

## Message Text

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TREASURY FOR F.L. WIDMAN AND DON SYVRUD FROM JIM AMMERMAN

E.O. 11652: N/A

TAGS: EFIN, UK

SUBJECT: FORECAST FOR U.K. ECONOMY IN 1976 AND 1977

BEGIN SUMMARY: HMG'S EXPORT AND INVESTMENT-LED GROWTH STRATEGY WILL BE SEVERELY TESTED OVER THE NEXT 18 MONTHS. THE STRENGTH AND DURABILITY OF THE RECOVERY WILL BE AFFECTED BY THE SHAPE OF WORLD DEMAND FOR BRITISH EXPORTS, CONTINUING TRADE UNION SUPPORT FOR WAGE RESTRAINT, AND A REBOUND IN PROFITS SUFFICIENT TO MAKE THE ANTICIPATED MANUFACTURING INVESTMENT BOOM MATERIALIZE. THERE APPEARS NO CHANCE OF REACHING THE CHANCELLOR'S GOALS OF REDUCING INFLATION TO SINGLE FIGURES BY THE END OF NEXT WINTER AND ACHIEVING AN "ECONOMIC MIRACLE" SCENARIO OF 4.5 TO 5 PERCENT REAL GROWTH THROUGH 1980. THERE IS STILL A CHANCE THE UK MIGHT BE ABLE TO MOVE INTO CURRENT ACCOUNT SURPLUS DURING 1978; THIS WILL DEPEND LARGELY ON NORTH SEA OIL. THROUGH 1977, THE UK WILL EXPERIENCE MODERATE GROWTH,

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WITH LITTLE IMPROVEMENT LIKELY IN CURRENT LEVELS OF UN-

EMPLOYMENT, THE CURRENT ACCOUNT DEFICIT OR RETAIL PRICE INFLATION. THIS MESSAGE SETS OUT OUR ASSUMPTIONS AND FORECAST FOR THE PERIOD THROUGH THE END OF 1977.

1. THE DOMESTIC ECONOMY; OUR MAJOR ASSUMPTIONS INCLUDE THE FOLLOWING: (PERCENT)

AVERAGE OF  
1976/75 1977/76

A. AVERAGE EARNINGS 13.5 8-10

THE 1976 FIGURE REFLECTS THE SIX POUND FIRST PHASE OF WAGE RESTRAINT WITH ABOUT 3 PERCENT SLIPPAGE. THE 1977 ESTIMATE IS BASED ON THE SUCCESSFUL IMPLEMENTATION OF THE STATED 4.5 PERCENT SECOND PHASE OF INCOMES POLICY. THE BOTTOM OF THE RANGE IS SLIGHTLY ABOVE HM TREASURY'S 7.5 PERCENT TARGET, WHILE THE 10 PERCENT FIGURE WOULD NECESSITATE A RISE IN OVERTIME WORKING WHICH WOULD BE CONSISTENT WITH INCREASED ECONOMIC ACTIVITY AND LITTLE REDUCTION IN UNEMPLOYMENT.

1976/75 1977/76

B. PRODUCTIVITY 4-5 2-3

THE 1976 IMPROVEMENT IN PRODUCTIVITY IS IN LINE WITH PREVIOUSLY CYCLICAL RECOVERIES.

C. GOVERNMENT SPENDING 2.5-3.0 0

CENTRAL AND LOCAL GOVERNMENT SPENDING APPEAR TO HAVE STOPPED INCREASING IN REAL TERMS DURING THE SECOND QUARTER OF 1976. THE ABOVE FIGURES ASSUME IMPLEMENTATION OF THE FY 77/78 CUTS ANNOUNCED IN JULY TOGETHER WITH SUCCESSFUL HMG EFFORTS TO INDUCE LOCAL AUTHORITIES TO HOLD THEIR OUTLAYS CONSTANT IN REAL TERMS. IN ORDER TO MEET THE 1977 TARGET, IT WILL BE NECESSARY FOR EITHER HMG OR LOCAL AUTHORITIES TO REDUCE THEIR MANPOWER LEVELS SINCE THERE IS LITTLE REMAINING ROOM TO ELIMINATE OR POSTPONE SCHEDULED CAPITAL SPENDING.

D. PRICE CODE RELAXATION

THIS IS LIKELY TO ADD ABOUT 1 PERCENT TO RETAIL PRICES THROUGH THE END OF 1977. A CONSIDERABLY HIGHER FIGURE IS POSSIBLE IN THEORY BUT THE CONTINUING SQUEEZE ON PERSONAL INCOMES WILL CREATE DEMAND CONDITIONS WHERE COMPETITIVE CONDITIONS SHOULD FORELIMITED OFFICIAL USE

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CLOSE THE POSSIBILITY OF SHARPLY HIGHER PRICES.

2. THE TABLE IN PARA. 5 BELOW CONTAINS OUR ESTIMATES FOR THE MAJOR ECONOMIC AGGREGATES. THE FOLLOWING DISCUSSION OUTLINES THE THINKING BEHIND THE ESTIMATES.

A. THE PERSONAL SECTOR:

THE AVERAGE CONSUMER WILL FIND HIS REAL DISPOSABLE INCOME UNDER INCREASING PRESSURE THROUGH THE END

OF 1977. WAGES AND EARNINGS WILL/BE RESTRAINED BY INCOMES POLICY WHILE RETAIL PRICE INFLATION WILL REMAIN ABOVE 10 PERCENT UNTIL QUITE LATE IN THE PERIOD. IN ORDER TO MAINTAIN EVEN PRESENT LIVING STANDARDS, CONSUMERS WILL HAVE TO DIP INTO ACCUMULATED SAVINGS. THE CURRENT DROP IN THE STILL ABNORMALLY HIGH SAVINGS RATIO (13.9 PERCENT IN 1975, PROBABLY 12.5-13.0 PERCENT THIS YEAR) REFLECTS THEIR WILLINGNESS TO DO SO. THIS DECLINE IS PREDICATED ON CONSUMER WILLINGNESS

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C O R R E C T E D C O P Y (TEXT)

NOT TO ADD TO THEIR NET LIQUID ASSET POSITIONS AS A RESULT OF LOWER INFLATION AND A SLIGHT DECLINE IN UNEMPLOYMENT. THE MARGINAL INCREASES IN REAL CONSUMER SPENDING ARE IN LINE WITH THESE EXPECTATIONS.

B. THE COMPANY SECTOR:

GROSS FIXED INVESTMENT SHOULD BEGIN TO FULFILL HMG'S HOPES IN 1977. HOWEVER, THE INCREASES ARE LIKE-

LY TO BE CONCENTRATED IN THE MANUFACTURING SECTOR WHICH TRADITIONALLY ACCOUNTS FOR ABOUT A FIFTH OF THE TOTAL. CAPITAL OUTLAYS BY THE GOVERNMENT IN HOUSING AND INVESTMENT IN THE NATIONALIZED INDUSTRIES WILL LAG. INVESTMENT IN NORTH SEA OIL DEVELOPMENT SHOULD PEAK IN 1976-1978 PERIOD.

THE SHARP INCREASE IN MANUFACTURING INVESTMENT DEPENDS IMPORTANTLY ON A CONTINUING IMPROVEMENT IN CORPORATE PROFITS. THE RELAXATION IN THE PRICE CODE TOGETHER WITH INCREASED PROFITABILITY OF EXPORTS SHOULD, TOGETHER WITH REDUCED PRESSURE ON LIMITED OFFICIAL USE

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LABOR COSTS, BOTH WIDEN MARGINS AND INCREASE TOTAL PROFITS THROUGH THE PERIOD. IN FACT, THE LIKELY SIZE OF THE PUBLIC SECTOR BORROWING REQUIREMENT AND THE ANTICIPATED DECLINE IN THE SAVINGS RATIO WILL CREATE STRONG PRESSURE ON FIRMS TO FINANCE NEW INVESTMENT THROUGH AUGMENTED INTERNAL CASH FLOW, MAKING IMPROVED PROFITS EVEN MORE CRUCIAL.

INVENTORY INVESTMENT ESTIMATES ARE MUCH MORE DIFFICULT; THE SHARP RUNDOWN DURING THE SECOND QUARTER OF 1976 IS PARTICULARLY PUZZLING GIVEN THE INCREASED IMPORTS OF RAW MATERIALS AND HIGHER INDUSTRIAL PRODUCTION WHICH OCCURRED DURING THE PERIOD. HOWEVER, PRELIMINARY INVENTORY FIGURES ARE GENERALLY SUBJECT TO CONSIDERABLE REVISION. THIS, TOGETHER WITH EVIDENT NEED FOR STOCKBUILDING OVER THE PERIOD, SEEMS TO PORTEND THE ONSET OF A PERIOD OF INVENTORY ACCUMULATION BEFORE THE END OF 1976.

C. INDUSTRIAL AND MANUFACTURING PRODUCTION:

INDUSTRIAL PRODUCTION APPEARED SET TO MOVE SOLIDLY UPWARD AFTER THREE MONTHS OF HEALTHY INCREASE IN THE SPRING. THE LOWER JUNE FIGURE WAS UNEXPECTED. MOST EXPLANATIONS HAVE CENTERED ON UNSEASONABLE HEAT AND FAULTY SEASONAL ADJUSTMENT FACTORS. AS A RESULT, IT SEEMS LIKELY THAT THE JUNE FIGURES WILL PROVE TO BE A RANDOM VARIATION AND THE INDEX WILL RESUME ITS UPWARD TREND OVER THE REMAINDER OF THE YEAR. TO DATE MOST OF THE RISE IN OUTPUT HAS CENTERED IN INTERMEDIATE GOODS INDUSTRIES, BUT THE CAPITAL GOODS SECTOR SHOULD BEGIN MAKING A POSITIVE CONTRIBUTION LATER IN THE PERIOD. CONSUMER GOODS OUTPUT WILL CONTINUE ON A VIRTUAL PLATEAU, WITH WHATEVER MARGINAL INCREASE COMING AS A RESULT OF RECORD SPENDING BY FOREIGN TOURISTS.

D. THE PUBLIC SECTOR:

OUR ASSUMPTIONS ON PUBLIC SECTOR SPENDING ARE IN PARA. 1C. IT SHOULD BE NOTED THAT HM TREASURY WORKED OUT FY 1977/78 CASH LIMITS ON THE ASSUMPTION THAT IN-

FLATION WOULD AVERAGE 7 PERCENT OVER THE PERIOD.  
THIS IS NOT A LIKELY OUTCOME. THEREFORE, THE CASH  
LIMITS WILL HAVE TO BE RIGOROUSLY ENFORCED WITH MOST  
SPENDING AGENCIES HAVING TO CUT OUTLAYS OVER THE PER-  
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IOD. WHILE HMG HAS ALREADY WARNED LOCAL AUTHORITIES  
OF THE NEED FOR SUCH CUTS, IT HAS EMPHASIZED THE NEED  
TO ACHIEVE THEM AT MINIMUM COST TO EMPLOYMENT. SUC-  
CESS AT THIS CONJURING TRICK WILL PROVE BEYOND THE  
CAPACITY OF MOST SPENDING AGENCIES. THERE SHOULD BE  
SOME LABOR SHEDDING IN THE PUBLIC SECTOR. THE ALTER-  
NATIVE WOULD BE A DEFEAT FOR THE GOVERNMENT'S PUBLIC  
SPENDING LIMITS.

THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)  
FOR THIS FISCAL YEAR AND NEXT WILL REFLECT CONTINUING  
HIGH LEVELS OF UNEMPLOYMENT. AS A PROPORTION OF  
GDP, THE PSBR WILL DROP BY 2-3 PERCENTAGE POINTS FROM  
ITS CURRENT RANGE OF 10-11 PERCENT. THIS IS CONSIS-  
TENT WITH THE TIGHTER FISCAL POLICY ANNOUNCED BY THE  
CHANCELLOR IN JULY AND RISING PUBLIC SECTOR REVENUES  
RESULTING BOTH FROM HIGHER COMPANY SECTOR TAX PAY-  
MENTS AND INCREASED TAX PAYMENTS BY THE PERSONAL SEC-  
TOR. FINANCING THE PSBR WITHOUT LARGE-SCALE BORROW-  
ING FROM THE BANKS WILL NOT BE SIMPLE. WHILE BOTH  
THE PERSONAL AND COMPANY SECTOR WILL BE IN SURPLUS,  
RISING CAPITAL SPENDING AND A DECLINING SAVINGS RATIO  
WILL PREEMPT SOME FINANCIAL RESOURCES WHICH MIGHT  
OTHERWISE HAVE GONE INTO GOVERNMENT DEBT. IN ORDER  
TO STAY WITH THE 12 PERCENT MONETARY AGGREGATE FORE-  
CASTS, THE GOVERNMENT MAY HAVE TO PERMIT SOME RISE IN

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INTEREST RATES.

3. GDP. TAKEN TOGETHER, THESE ESTIMATES ARE CONSISTENT WITH REAL GDP GROWTH IN 1976 OF 3.0 PERCENT AND IN 1977 OF BETWEEN 3.5 AND 4.25 PERCENT. THESE FIGURES, WHILE SOMEWHAT ABOVE THE LONG TERM TREND, FALL CONSIDERABLY SHORT OF THE CHANCELLOR'S ECONOMIC MIRACLE. THROUGH MOST OF THE PERIOD, INFLATION WILL STILL BE IN DOUBLE DIGITS, UNEMPLOYMENT WELL ABOVE A MILLION AND THE 5 PERCENT LEVEL; DESPITE NORTH SEA OIL, THERE WILL BE A SERIOUS CURRENT ACCOUNT DEFICIT. ALL THIS SAID, THE CHANCELLOR'S GOALS OF INVESTMENT AND EXPORT-LED GROWTH REMAIN THE ONLY VIABLE ONES IF THE U.K. IS TO REGAIN RELATIVE ECONOMIC HEALTH. THIS IN TURN ENTAILS CONTINUING TO HOLD DOWN PUBLIC AND PRIVATE CONSUMPTION UNTIL THE STRATEGY TAKES HOLD -- AND IT WILL BE PAINFUL.

4. THE EXTERNAL SECTOR. THE 1976 CURRENT ACCOUNT DEFICIT SHOULD LIE IN THE RANGE 1700-2000 MILLION POUNDS, AND THE 1977 DEFICIT IN THE RANGE 1500-1800 MILLION POUNDS.  
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ALTHOUGH ROUGHLY THE SAME MAGNITUDE AS THE 1670 MILLION POUND 1975 DEFICIT, THE INCREASE IS ENTIRELY ATTRIBUTABLE TO THE DEPRECIATION OF THE POUND WHOSE TRADE WEIGHTED VALUE IS EXPECTED TO DECLINE 14 PERCENT BETWEEN 1975 AND 1976 AND AN ADDITIONAL 3 TO 4 PERCENT IN 1977.

EXPORT VOLUME IS EXPECTED TO GROW BY ROUGHLY 7 PERCENT IN 1976 AND 5 PERCENT IN 1977. OTHER FORECASTS INDICATE LARGE INCREASES, BUT THE AVAILABLE STATISTICS SHOW ONLY AN IRREGULAR WEAK EXPORT PERFORMANCE IN 1976 POUND EXPORT PRICES ARE ESTIMATED TO INCREASE AT ABOUT 18 PERCENT IN 1976 AND 9 PERCENT IN 1977.

THE VOLUME OF NON-OIL IMPORTS IS EXPECTED TO GROW BY APPROXIMATELY 4 PERCENT IN BOTH 1976 AND 1977. TO SATISFY THE REQUIREMENTS OF ECONOMIC RECOVERY. POUND PRICES OF NON-OIL IMPORTS SHOULD INCREASE ABOUT 22 PERCENT IN 1976 AND 12 PERCENT IN 1977. THESE PRICE MOVEMENTS IMPLY A FALL IN THE U.K. TERMS OF TRADE, THAT IS WIDELY ANTICIPATED BUT AS YET UNOBSERVED.

PETROLEUM IMPORTS SHOULD RISE SLIGHTLY FROM A 1975 LEVEL OF 3800 MILLION POUNDS TO 4100 MILLION IN 1976, THEN FALL TO 3700 MILLION IN 1977 IF OIL SHOWS NO DOLLAR PRICE INCREASE IN 1977. A 10 PERCENT INCREASE IN THE DOLLAR PRICE OF OIL ON JANUARY 1, 1977 WOULD INCREASE THE U.K.'S OIL IMPORT BILL BY ABOUT 200 MILLION POUNDS. THE RELATIVELY CONSTANT LEVEL OF THE VALUE OF PETROLEUM IMPORTS IS THE NET RESULT OF BURGEONING NORTH SEA OIL PRODUCTION BEING OFFSET BY INCREASED CONSUMPTION AND BY THE DEPRECIATING POUND.

THE BALANCE ON INVISIBLES SHOULD REACH A SURPLUS OF 1600 MILLION POUNDS IN 1976, BUT SHOULD BE HELD AT OR BELOW THAT LEVEL IN 1977 DUE TO, INTER ALIA, RISING INTEREST PAYMENTS ON THE GROWING EXTERNAL DEBT OF THE PUBLIC SECTOR.

ONE REASONABLE SCENARIO FOR THE CURRENT ACCOUNT, IF IT IS TOWARD THE OPTIMISTIC END OF THE EXPECTED RANGE (ASSUMING NO PRICE INCREASE IN OIL, AND CONSIDERABLE RAIN) COULD BE PRESENTED AS FOLLOWS:

CURRENT ACCOUNT  
(MILLIONS OF POUNDS)

	1976	1977
EXPORTS (F.O.B )	23,700	27,200
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NON-OIL IMPORTS (F.O.B.)	-23,000	-26,900
OIL IMPORTS (F.O.B.)	- 4,100	- 3,400
BALANCE ON VISIBLE		
TRANSACTIONS	- 3,400	- 3.100
BALANCE ON INVISIBLE		
TRANSACTIONS	1,600	L,500
BALANCE ON CURRENT ACCOUNT	- 1,800	- L,600

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5. THE FOLLOWING TABLE REPRESENTS OUR BEST ESTIMATES OF THE PERFORMANCE OF THE BRITISH ECONOMY THROUGH 1977. (FIGURES A THROUGH E ARE AVERAGE ANNUAL PERCENTAGE CHANGES.)

	1975	1976	1977
A REAL GDP (OUTPUT)	-1.6	2.8-3.0	3.5-4.25
B INDUSTRIAL PRODUCTION	-5.0	2.8-3.0	4.0-5.0
C GROSS FIXED INVESTMENT	-0.4	0-0.3	4.0-5.0
D MANUFACTURING INVESTMENT	-13.7	-5.5 TO -6.5	15 TO 20
E RETAIL PRICES	24.2	15.5-16.0	10 TO 12
F UNEMPLOYMENT (DEC.S.A.)	1.2	1.25-1.3	1.15-1.2

NOTE: THE FOLLOWING ARE

IN BILLIONS OF POUNDS:

G TRADE ACCOUNT -3.2 -3.3 TO -3.6 -3.0-3.3

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H INVISIBLE ACCOUNT 1.5 L.6 L.5

I CURRENT ACCOUNT -1.7 -1.7 TO -2.0 -1.5 TO -1.8

OUR ESTIMATES TAKE ACCOUNT OF A POTENTIAL OIL PRICE



INCREASE OF 10-15 PERCENT AND TRY TO MAKE SOME MODEST ALLOWANCE FOR DROUGHT EFFECTS. REPORTS ARE THAT THE HARVEST THIS YEAR WILL BE THE WORST IN SIX YEARS. WATER SHORTAGES IN SOME AREAS WILL HAVE A NEGATIVE IMPACT ON INDUSTRIAL PRODUCTION. THE OVERALL EFFECT WILL BE HIGHER IMPORTS OF FOOD AND FEED, HIGHER PRICES, AND REDUCED PRODUCTION. BUT AT THIS TIME IT IS NOT POSSIBLE TO SPECIFICALLY QUANTIFY THE EFFECTS WHICH WILL WORSEN AS THE DROUGHT CONTINUES.

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